This record is a partial extract of the original cable. The full text of the original cable is not available.

UNCLAS SECTION 01 OF 03 TEGUCIGALPA 003004

SIPDIS

SENSITIVE

STATE FOR WHA/CEN, WHA/ESPC, AND EB/IFD/OMA
STATE PASS AID FOR LAC/CEN
STATE PASS USTR, EXIM AND OPIC
STATE PASS USED IDB, USED WB, AND USED IMF
TREASURY FOR JOHN JENKINS

LABOR FOR ILAB, ROBERT WHOLEY
PANAMA FOR CUSTOMS

E.O. 12958: N/A

TAGS: EFIN ECON EAID ETRD ELAB PGOV HO
SUBJECT: GOH Faces Unpalatable Choices on Increasing Government Revenues

----
Summary

¶1. (SBU) A new IDB-sponsored diagnosis of structural problems in Honduras's tax policy documents the failure of the GOH to raise sufficient revenues to fund vital state functions, resulting in steady growth in the central government's fiscal deficit. The authors recommend an immediate repeal of extensive tax exemptions and loopholes that have reduced the tax base significantly over the years, and a long-term structural overhaul of the tax system. These sensible and needed recommendations will be overwhelmingly difficult to implement in the Honduran political context and it remains to be seen how tough the IMF will be. There is high-level political commitment to work on an equally important improvement of Honduras' tax administration (collection and audits), with help from the U.S. Treasury Department's tax administration technical assistance office. The high percentage of Honduran tax receipts collected by customs officials indicates that a customs service technical assistance project may be needed as well. Washington agencies preparing for U.S.-Central American Free Trade Agreement (USCAFTA) negotiations may wish to consider carefully our position on GOH tax incentives for non-traditional exporters (including U.S. companies) in the context of the investment chapter. End Summary.

--- -------
Honduran Tax Collection: Too Low, Too Unfair and Too Uncontrolled
--- -------

¶2. (SBU) A team of consultants hired by the IDB is currently putting the finishing touches on a report entitled "Honduras: Toward a More Transparent and Diversified Tax System." The study repeats the recommendations of earlier studies and analyses. It is well-documented, albeit based on Honduras' extremely limited statistical data base, and provides policymakers the kinds of details needed to target loopholes in Honduran tax law. Obtaining a substantial increase in tax revenues in the near-term is going to be an important issue in upcoming Article IV review and discussion of a new three-year Poverty Reduction and Growth Facility program with the IMF team that is expected to arrive November 4. To ensure adequate attention and coordination on this aspect of macroeconomic policy, the USAID mission in Honduras has coordinated an extremely useful series of meetings of the G-15 Macroeconomic group to evaluate Honduras' tax system. At a recent meeting of this donor group, the key results of the IDB study were presented and discussed.

¶3. (SBU) The scope of the problem is fairly clear. Honduras collects (using official measures) taxes equivalent to 16 percent of GDP. Assuming GDP in Honduras is underestimated by 35 percent, this tax receipt measure falls to 12 percent of GDP using the appropriate estimate of GDP. The World Bank advises that this is only half of the percentage that is considered healthy for a developing country. This level of tax collection is not adequate to fund the key government services and investment that are needed; growth in tax receipts has not kept up with expenditure growth over the last ten years, resulting in ever growing deficits (with the exception of 1995-98). The percentage of government expenditures that were covered by tax revenues has declined from 88 percent of GDP in 1998 to only 63 percent in 2001. The tax structure also is highly regressive, since most of the tax exemptions are provided to the wealthy. The poorest Hondurans pay a percentage of their income in taxes that is 75 percent higher than the average taxpayer, whereas the

richest Hondurans pay a percentage of their income in taxes that is 20 percent lower than average.

¶4. (SBU) The IDB consultants noted that the rapid growth in the public sector wage bill in recent years (up from 45 percent of tax receipts in 1997 to more than 60 percent in 2001) as a result of the wage provisions in the special framework laws (estatutos) for teachers and health service professionals. They also commented that the size of the state is not the real problem. They noted that Honduras' central government budget as a percentage of GDP is smaller than even Nicaragua's. The state simply does not collect enough revenue. Finally, the lack of sufficient income has led the GOH to fail to transfer five percent of net government income to municipalities, as required by the Municipality Law that went into effect in January 1991.

¶5. (SBU) As the GOH began to reduce customs tariffs in 1991 in an effort to liberalize trade, the sales tax (a modified VAT tax) has gradually grown in importance and now accounts for 33 percent of total government tax revenues. Income tax accounts for 22 percent of tax receipts, and taxes on oil and oil products come in third, representing 21 percent of total taxes. The 1990s were also a period of export promotion, resulting in a web of generous tax incentives for textile and apparel companies, mining, and tourism services. The IDB team notes that the country has paid a high price for these incentives, in terms of transparency, fair treatment across taxpaying groups, and control of its own tax administration.

¶6. (SBU) Although only 12 percent of tax receipts come from import duties, the IDB report notes that 50 percent of all tax revenues (including customs duties, sales tax, excise taxes, etc.) are collected by the customs service. Tax payments are highly concentrated. In the year 2000, 703 large companies paid 77 percent of the income tax and 1,129 large firms accounted for three-quarters of sales tax payments.

¶7. (SBU) The IDB study also noted the weakness of the Honduran tax and customs service, the DEI. Although some improvements have been made (including the new installation of an automated tax payment transfer system integrated with the commercial banks, a project paid for by the IDB), there remains a great deal of work to do. Note: The U.S. Department of Treasury's tax administration technical assistance project begins in earnest at the beginning of November. This work will focus on tax collection and auditing. The Treasury experts have recommended that the Embassy also contact U.S. Customs about possible technical assistance for the DEI's customs operations. End Note.

¶8. (SBU) Extensive exemptions are provided in almost all the tax categories, resulting in a greatly reduced tax base. A wide range of companies receive exemptions from the sales tax for purchases of raw materials and other inputs. As result of the granting of extensive exemptions from customs duties, revenues from this tax source are only 56 percent of the theoretical tax collection (calculated by multiplying the value of imports by the appropriate ad valorem tariff). In addition, the consultants estimate that 41 percent of imported goods enter the country exempt from sales tax as well.

¶9. (SBU) Tax incentives have been provided to the majority of manufacturing and assembly firms (operating in free trade zones of several types) and companies in the tourism, mining and energy fields, providing these companies with exemptions from customs duties, sales tax, and income tax. Current administration of these exemptions provides ample opportunity for abuse. It is believed that at least one firm in the power sector is reselling large quantities of fuel to gas stations, instead of using the tax-exempt product strictly for electricity generation. Many goods imported duty-free as inputs for assembly or manufacturing are instead sold on the retail market.

Solutions Are All Politically Unpalatable

¶10. (SBU) The IDB team recommended a series of changes to the tax code, for the short term, designed to broaden the tax base for the GOH's main revenue sources. They believe these measures would increase tax collections by two percent of GDP, annually. The key provisions in this list are the elimination or dramatic reduction of tax exemptions and the application of minimum amounts of taxes to limit tax avoidance schemes. As these tax exemptions benefit the largest and most important companies and individuals in the country, and in many cases these changes would be tantamount to violation of contractual terms and shifting rules of the game for investors, many donors are skeptical that sufficient political will exists for major tax policy shifts.

¶11. (SBU) For this reason, some experts are proposing that the GOH raise the sales tax in order to increase revenues quickly, lower the fiscal deficit, and allow the government to reach an agreement with the IMF. Some of these observers cite the case of Chile, in which an eighteen percent tariff is applied across the board, with almost no exceptions. In Chile and Mexico, these analysts noted, the sales tax is not nearly as regressive as one would think, because the elimination of exemptions and incentives ensures that the wealthier part of the population is not able to avoid taxes. While the simplicity and effectiveness of this approach is attractive (and senior advisors in the GOH have noted that this was the case when the sales tax was raised from seven to twelve percent in 1998), it would put the GOH on the political defensive for raising taxes on the poor and allowing the rich to continue receiving exemptions.

Comment

¶12. (SBU) We expect that the IMF will push the GOH to increase tax revenue in order to help achieve macroeconomic stability. The GOH is well advised to improve its tax administration, but this will not be sufficient to achieve fiscal balance. At least some tax exemptions will need to be eliminated to help reduce the budget deficit. While raising the sales tax represents a simple alternative, we believe it would be politically difficult in the current context of high unemployment and slow growth. The GOH may also look to privatization and concessions of government infrastructure projects, as a way of both increasing government revenues and improving efficiency (currently, the only privatization proceeds that are included in the 2003 budget are the planned sale of a wireless phone concession). The final important factor is economic growth. If Honduras can find a way to improve its investment climate sufficiently, it may be able to grow itself out of the conundrum it finds itself in.

Pierce